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CHARLES ELSON KELLEY

No. 948

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**In the Supreme Court of the United States**

OCTOBER TERM, 1944

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**THE JOHN KELLEY COMPANY, PETITIONER**

**v.**

**COMMISSIONER OF INTERNAL REVENUE**

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**ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH  
CIRCUIT**

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**BRIEF FOR THE RESPONDENT IN OPPOSITION**

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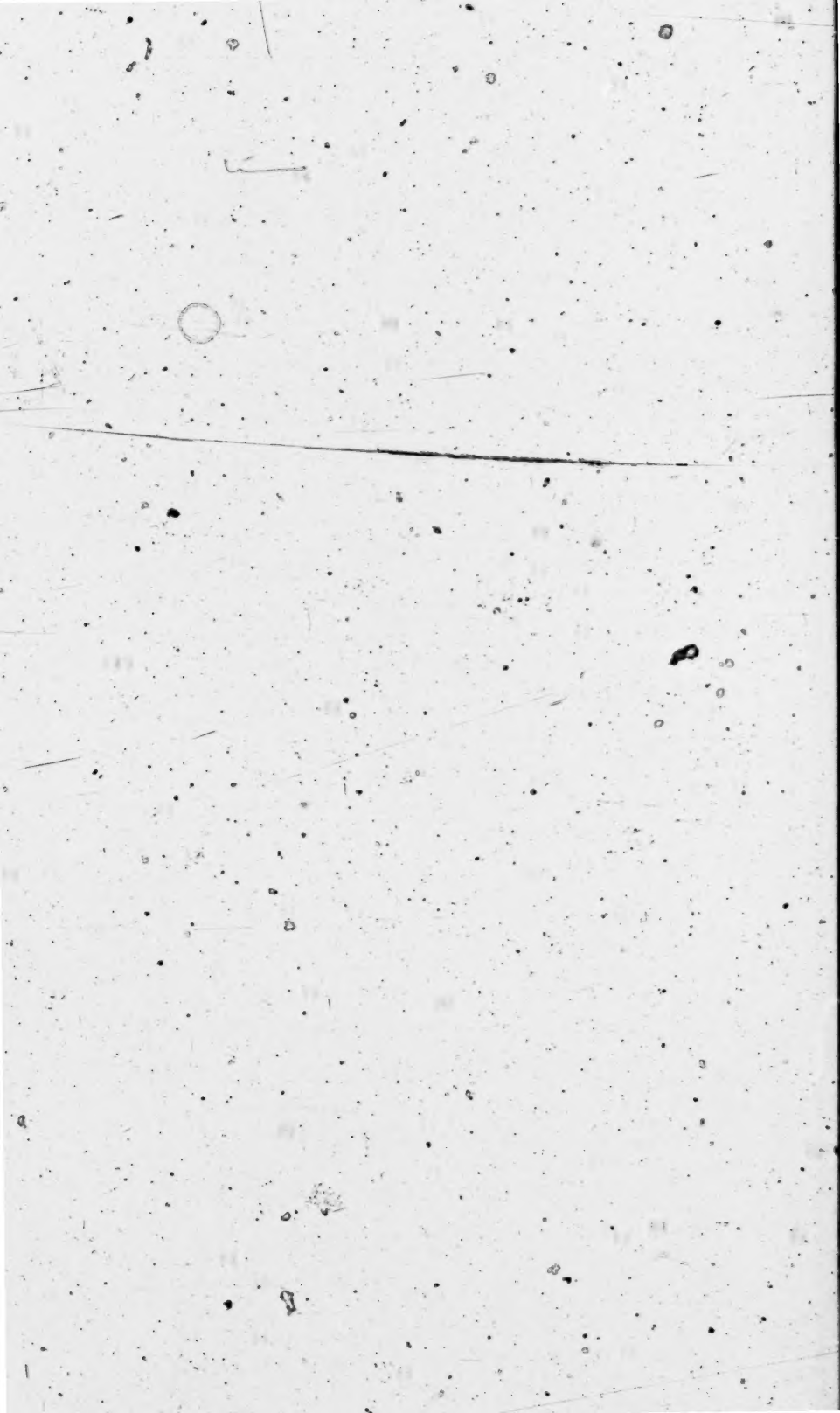
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## **BRIEF FOR THE RESPONDENT IN OPPOSITION**

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### **OPINIONS BELOW**

The opinion of the Tax Court (R. 33-40) is reported at 1 T. C. 457; the opinion of the Circuit Court of Appeals (R. 55-59) is reported at 146 F. 2d 466.

### **JURISDICTION**

The judgment of the Circuit Court of Appeals was entered on December 21, 1944. (R. 60.) The petition for a writ of certiorari was filed February 14, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

### QUESTION PRESENTED

Whether amounts paid by the petitioner corporation in the years 1937, 1938 and 1939 on its so-called eight per cent income debentures were deductible as interest on indebtedness within the meaning of Section 23 (b) of the Revenue Act of 1936 and identical provisions of the Revenue Act of 1938 and of the Internal Revenue Code, or were in reality non-deductible dividend distributions.

### STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

#### SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

\* \* \* \* \*

(b) *Interest*.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.

\* \* \* \* \*

#### SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend*.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means

any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

\* \* \* \* \*

Sections 23 (b) and 115 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code (26 U. S. C., Secs. 23 and 115) are identical with the above.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (b)-1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, \* \* \*

\* \* \* \* \*

\* \* \* So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income. \* \* \*

Article 23 (b)-1 of Regulations 101, promulgated under the Revenue Act of 1938, and Section 19.23 (b)-1 of Regulations 103, promulgated under the Internal Revenue Code, are identical with the above.



## STATEMENT

The facts as stipulated and as found by the Tax Court may be stated as follows (R. 34-39):

Petitioner is an Indiana corporation, organized in 1907 and reorganized in 1930, and has its principal place of business in Marion, Indiana. It is engaged in the retail furniture business. Its income tax returns for the calendar years 1937, 1938, and 1939 were prepared from books kept on the accrual basis. The returns were filed with the Collector of Internal Revenue at Indianapolis, Indiana. (R. 34.)

On January 1, 1937, the petitioner had authorized as capital stock 1,500 shares of common stock at no par value and 3,000 shares of preferred stock at \$100 par value, of which 1,110 shares of common stock and 1,124 shares of preferred stock had been issued and were outstanding. Roy F. Kelley, individually, owned 567 shares of common stock and 628 shares of preferred stock, and, as trustee for Mabel K. Ronald, he owned 543 shares of common stock and 496 shares of preferred stock; Mabel K. Ronald was a sister of Roy F. Kelley. (R. 34.)

During the month of January, 1937, Roy F. Kelley transferred the 628 shares of preferred stock and 171 of the common shares owned by him in his own right; 50 shares of preferred to Mabel K. Ronald, as trustee for her daughters, Ruth Stevens Korper and Mary Louise Stogsdill;

289 shares of preferred to Mabel K. Ronald as trustee for Ruth Stevens Korper; 289 shares of preferred to Mabel K. Ronald as trustee for Mary Louise Stogsdill; and the 171 shares of common stock to his wife, Birdena Kelley. It was provided in the above three trusts, however, that Birdena Kelley should receive the income from the 628 shares of preferred stock during her lifetime. (R. 34.)

On January 11, 1937, a special meeting of the board of directors of the petitioner corporation was held and a plan of recapitalization was adopted. Following that meeting, and on the same date, the shareholders of the corporation held a special meeting and approved the resolution adopted by the board of directors. Under this resolution the authorized issue of 1,500 shares of common stock of no par value was changed to 1,500 shares of common stock with a par value of \$100 per share and then increased to 6,000 shares. The resolution also authorized the issue of "income debenture bonds" aggregating the sum of \$250,000, bearing interest at the rate of eight percent per annum, and the execution of a trust agreement setting forth the terms and conditions upon which the debenture bonds were issued and the power and duties of the trustees. Under the resolution the income debenture bonds would be offered by the trustees in exchange for the issued and outstanding 1,124 shares of the preferred



stock on the basis of \$102 in face value of debentures for each share of the preferred stock; and, for the purpose of raising additional capital to expand the business of the corporation "in the field of finance," the trustees were to offer any and all unissued debenture bonds for sale at face value to the shareholders of the corporation. The directors' meeting was attended by the three directors, Mabel K. Ronald, Roy F. Kelley, and Mary Louise Stogsdill, and the holders of the entire capital stock of the corporation, Mabel K. Ronald and Roy F. Kelley, were present at the meeting of the shareholders. (R. 34-35.)

The trust indenture dated January 1, 1937, was entered into by the petitioner corporation through its president, Mabel K. Ronald, and secretary, Roy F. Kelley, with the trustees, Mabel K. Ronald and Roy F. Kelley. None of the income debenture bonds was issued prior to July 1, 1937. On that date Roy F. Kelley, as trustee for Mabel K. Ronald, delivered to the petitioner 496 shares of preferred stock, and simultaneously there were delivered to Roy F. Kelley, as trustee for Mabel K. Ronald, \$50,592 face amount of the bonds. On the same date, Mabel K. Ronald, as trustee for Ruth Stevens Korper and Mary Louise Stogsdill, delivered to the petitioner 628 shares of preferred stock, and there were delivered to Mabel K. Ronald, as trustee for the same beneficiaries, \$64,056 face amount of the income debenture

bonds. On July 1, 1937, Mabel K. Ronald and Birdena Kelley subscribed for \$24,408 and \$10,944, respectively, of the bonds. These amounts were carried against them in open accounts on the books of the petitioner and were later wiped out by the credit of dividends received by them on common stock. In the case of Mabel K. Ronald the dividends so credited were on the common stock held for her by Roy F. Kelley, as trustee, while in the case of Birdena Kelley the dividends were on the 171 shares of common stock which had been transferred to her by Roy F. Kelley in January of 1937. (R. 35.)

Petitioner, on December 10, 1937, filed articles of amendment of its articles of incorporation with the Secretary of State of Indiana, which showed the total number of shares of its capital stock to be 3,000 shares of preferred stock having a par value of \$100 each and 6,000 shares of common stock having a par value of \$100 each. (R. 35-36.)

On December 15, 1937, 1,110 outstanding shares of common stock of the petitioner were held as follows: 396 shares by Roy F. Kelley; 171 shares by Birdena Kelley; and 543 shares by Roy F. Kelley, as trustee for Mabel K. Ronald. A cash dividend of \$55 per share was paid on 1,110 shares on December 15, 1937, after which a common stock dividend of  $3\frac{1}{2}$  shares for each share of common stock held was declared and paid by petitioner. (R. 36.)

During the periods of July 1 to December 31, 1937; January 1 to December 30, 1938; and January 1 to December 31, 1939, the petitioner had outstanding "income debenture bonds" of the face amount of \$150,000, in respect of which \$6,000, \$12,000, and \$12,000 for each period, respectively, were set up on the books as accrued interest thereon. The amounts so accrued were paid and were claimed by petitioner as deductions in computing its taxable net income for the respective calendar years 1937, 1938, and 1939. These deductions were disallowed by the Commissioner. (R. 36.)

On the petitioner's books the "income debentures" were referred to as "stock", "bonds", and "notes". Charges were entered in an account which was headed "accrued interest, income debentures". In its capital stock tax returns for 1938 and 1939 it listed "debenture" and "debenture notes", respectively, as capital stock. They were not reflected as indebtedness in the balance sheets appearing in the income and excess profits tax returns filed by petitioner for 1937, 1938, and 1939, but appear under the heading "Capital Stock: Debenture Notes". The board of directors annually adopted corporate resolutions authorizing the payment of "interest" on the "income debenture bonds" or "debenture notes". On most of the checks, drawn for the "interest" on the "income debentures" to the

holders thereof, the nature of payment was described as "Interest, income debenture stock". (R. 36.)

On January 1, 1937, the assets of petitioner totaled \$963,807.57 and its liabilities, exclusive of common and preferred stock, totaled \$75,817.74. On December 31, 1937, its total assets were \$982,221.08 and its total liabilities, exclusive of common stock and the debentures, were \$46,158.19. (R. 36-37.)

The trust indenture set out the form of debenture to be issued, which was substantially followed, and the debentures in controversy read in part as follows (R. 37):

THE JOHN KELLEY COMPANY, an Indiana corporation, for value received, promises to pay to the bearer on the 31st day of December, 1956, the sum of ONE THOUS. ND DOLLARS (\$1,000) in lawful money of the United States of America at the office of the Company in Marion, Indiana, and to pay interest thereon in like lawful money, out of the net income of the Company, at the rate of 8% per annum, payable annually on the 31st day of December of each year, at the office of the Company in Marion, Indiana, on presentation of this Debenture for endorsement of payment thereon, conditioned, however, upon the net income of the Company being sufficient during any interest period to pay the amount due as interest, in accord with the

terms and provisions hereof. The interest on this Income Debenture shall not be cumulative.

\* \* \* \* \*

If any of the events of default specified in the trust agreement shall occur, all debentures outstanding hereunder may be declared to be due and payable in the manner and with the effect provided in the trust agreement.

In the payment of their claims, all creditors, other than the stockholders of the Company, shall rank superior to the holders of this income debenture, but all holders of this income debenture shall rank *pari passu* with each other and superior to the stockholders of the corporation with respect to their share stock.

Article IV of the trust indenture set forth "Default and Remedies", and further provided (R. 37-38):

SECTION 1. If one or more of the following events of default happen, viz; (a) if default be made in the punctual payment of any installment of interest on any outstanding debenture or debentures or (b) if default be made in the observance or performance of any of the terms of said debentures or of this Trust Agreement, and any such last named default shall continue for a period of two (2) years after written notice thereof shall have been given to the Company by the Trustees (whose duty it



shall be to give such notice at the request in writing of at least twenty-five per cent (25%) in principal amount of the debentures at the time outstanding hereunder), then and in every such case, the Trustees may, and upon the written request of the holders of twenty-five per cent (25%) in principal amount of the debentures then outstanding hereunder shall declare the principal of all debentures then outstanding hereunder to be due and payable immediately, and upon any such declaration the same shall become immediately due and payable, anything in this Trust Agreement or in said debentures contained to the contrary notwithstanding.

The trust indenture provided certain procedure to be followed by the trustees and debenture holders in enforcing payment of the interest and principal, in case of default by the petitioner. In one provision the petitioner pledged that all of its property was free of mortgage and no lien or any other encumbrance would be placed upon it as long as any of the debentures were outstanding. It was also provided that the debentures were subordinate to the claims of petitioner's creditors but had priority over the claims of the stockholders. The holders of the debentures were not given the right to participate in the management of the business. (R. 39.)

The Commissioner disallowed the deductions claimed for interest paid in each of the taxable



years (R. 7-12) and determined deficiencies in income tax for the calendar years 1937, 1938, and 1939 in the amounts of \$569.06, \$1,980 and \$1,980 respectively, and \$360 in excess profits tax for the year 1937. (R. 33.) The Commissioner did, however, increase the dividends-paid credit by the amounts of \$6,000, \$12,000 and \$12,000 in computing the petitioner's surtax on undistributed profits for the years involved. (R. 40.)

The Tax Court held that those amounts were deductible as interest paid on indebtedness (R 40) and determined that there were no deficiencies in taxes for the years in question (R. 41). On the Commissioner's petition for review, the Circuit Court of Appeals for the Seventh Circuit, holding in substance (R. 55-59) that the debentures clearly evidenced risk capital rather than creditor capital, reversed the Tax Court decision.

#### ARGUMENT

There is no occasion for further review of this case. The decision of the Circuit Court of Appeals is in accord with recent rulings of this Court; and no conflict among the circuits is presented.

1. The petitioner asserts that under *Dobson v. Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231, and *Commissioner v. Scottish American Co.*, 323 U. S. 119, the Tax Court's disposition of this case should be accepted as final.

This contention, we believe, reflects a misconception of the character of error which the court below undertook to rectify. Section 23 (b) of the pertinent Acts, *supra*, allows deduction for "interest \* \* \* on indebtedness". Article 23- (b) of Treasury Regulations 94, promulgated under the Revenue Act of 1936, *supra*, and the counterparts of that article under the Revenue Act of 1938 and the Internal Revenue Code, *supra*, declare negatively that—

so-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted \* \* \*

Thus both statute and regulations contain two prerequisites to deductibility: the obligations on which the payments are made must constitute true "indebtedness", and the payments themselves must actually be "interest". See *Talbot Mills v. Commissioner* (C. C. A. 1st), decided December 22, 1944 (1945 C. C. H., par. 9122).

The opening sentence of the Tax Court opinion, however, stated (R. 39) the issue of the case at bar to be only—

If the debentures have created an indebtedness the payments to the holders thereof are interest and deductible as expense, but if they are in fact capital stock the payments are dividends and not deductible.

Thus the Tax Court assumed as a matter of law that if the petitioner's "income debentures" evi-

dence "indebtedness" the payments made thereon were necessarily "interest"; and it was on that assumption of law that it held that they were. We think that such assumption was erroneous; and that our contention in the court below that it was erroneous raised an issue of law which that court was authorized to consider and pass upon. The question of what standards or criteria are laid down by statute is clearly one of law. *Powers v. Commissioner*, 312 U. S. 259, 260; *Helvering v. Amer. Dental Co.*, 318 U. S. 322, 330-331; *Dobson v. Commissioner*, 320 U. S. 489, 492-493; *Equitable Society v. Commissioner*, 321 U. S. 560; *Security Flour Mills Co. v. Commissioner*, 321 U. S. 281; *Dixie Pine Co. v. Commissioner*, 320 U. S. 516.

Particularly pertinent here is this Court's decision in *Equitable Society v. Commissioner*, *supra*, which was rendered subsequent to the Tax Court decision but prior to the decision of the court below. In the *Equitable* case, the Tax Court had denied a deduction claimed as "interest" paid on "indebtedness" within the meaning of Section 203 (a) (8) of the Revenue Act of 1932, defining the "net income" of life insurance companies. In reviewing the Circuit Court of Appeals' affirmation of the case, this Court itself determined, on the basis of the stipulated facts and the provisions of the relevant insurance policies, whether the "excess interest dividends" there involved were "interest" within the meaning of the stat-

ute;<sup>1</sup> it held that they were not. By parity of reasoning, it would appear that the Circuit Court of Appeals in this case was authorized to determine, on the basis of the stipulated facts and the provisions of the instruments here, whether the Tax Court had erred in holding (1) that the obligations at bar constituted "indebtedness" within the meaning of the statute, and (2) that it followed as a matter of course that the payments in question were "interest" within Section 23 (b).

This Court recently reviewed a decision of a Circuit Court of Appeals reversing the Tax Court on the question whether compensation for personal services was realized upon the exercise of a stock option. *Commissioner v. John H. Smith*, No. 371, decided February 26, 1945. While disapproving the result reached by the Circuit Court of Appeals, it was recognized that a reviewable question was presented because—

the Tax Court concluded as a matter of law that the facts which it found \* \* \* brought the case, for the tax year 1938, within the provisions of Section 22 (a) of the Revenue Act of 1938, and of the interpretative Treasury Regulations 101, Art. 22 (a)-1; \* \* \*

Similarly, in reviewing the Tax Court's decision that the payments in question come within the

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<sup>1</sup> The case did not present the question of whether the obligations themselves were "indebtedness."

scope of Section 23 (b) and the interpretative regulation, the Circuit Court of Appeals in the present case was not invading the province of the Tax Court. It was merely inquiring whether the Tax Court had correctly applied the law to the facts which it had found.<sup>2</sup>

2. So far as the merits are concerned, we submit that the decision of the court below was correct. In passing upon the question of whether the petitioner's "income debentures" evidenced "indebtedness", the Tax Court seems to have fallen into error in applying the mandate of the regulations that the obligation upon which the payments are made shall not, in actuality, be preferred stock. Examination of the instruments at

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<sup>2</sup> The petitioner contends (Br. 9) that the court below "refused to recognize a finding of fact made by the Tax Court, namely, that the issuance of the bonds was a bona fide transaction"; and that the appellate court "made its own finding of fact, namely, that the transaction was 'all a matter of accounting hocus-pocus' (R. 59), which finding is the direct opposite of the finding made by the Tax Court." Petitioner further states (Br. 9) that the Circuit Court of Appeals decision "is based squarely on the aforesaid finding of fact made by it." However, the Tax Court made no finding with respect to the bona fides of the transaction; and while the court below did state (R. 59) that the conversion from stock to so-called income debentures was "all a matter of accounting hocus-pocus," that was not the basis of its decision. Reversal was grounded on the statement preceding the one to which petitioner refers, namely (R. 59): "Such debentures obviously evidenced risk capital, not creditor capital." The question is not one of motivation; it is one of accomplishment. Cf. *Gregory v. Helvering*, 293 U. S. 465.



bar shows that these obligations had every aspect of preferred stock and none of the aspects of debt except one<sup>3</sup>—they had a fixed maturity date. But as the court below pointed out (R. 58), it is not uncommon today for preferred stock to carry a retirement date; in fact such is expressly authorized by petitioner's domiciliary law. Petitioner's 1937 "conversion" from stock to indentures was manifestly nothing more than a *pro forma* change; in reality, the pre-conversion proprietary interests of the holders continued unaltered.

Furthermore, as we have previously noted, even on the assumption that the Tax Court was correct in holding these obligations constitute "indebtedness" as to principal, it does not follow, as the Tax Court thought, that the payments in question satisfied the statutory concept of "interest". The opinion of the Circuit Court of Appeals plainly reveals the non-sequitur in the Tax Court's reasoning.

In *Deputy v. duPont*, 308 U. S. 488, 498, this Court defined interest as "compensation for the use or forbearance of money". The Tax Court did not find that there was any "use or forbearance of money" in the instant case; and it is evi-

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<sup>3</sup>It is true that the instruments themselves were formally denominated "Income Debentures", but as the Tax Court found (R. 36), they were more often referred to, and treated by petitioner, as stock.



dent from the facts which it did find (R. 34-36) that there was none. Furthermore, in the *Equitable* case, *supra*, this Court pointed out that the concept of "interest" does not embrace amounts payable upon a contingency; and here, as the critical instruments unequivocally recite (R. 37), the so-called "interest" was not cumulative and never became payable unless there were earnings during each annual period.<sup>4</sup> And, as this Court also observed in the *Equitable* case (p. 564), it is not material that the contingency to payment—here the sufficiency of earnings—may have happened.<sup>5</sup>

<sup>4</sup> This serves to distinguish *Commissioner v. H. P. Hood & Sons*, 141 F. 2d 467 (C. C. A. 1st), upon which petitioner relies (Br. Point 3) as creating a conflict. In the *Hood* case, the Circuit Court of Appeals construed the pertinent contracts as providing that interest was in all events collectible at the maturity date of the principal. In the *Hood* case, too, a certain amount of the obligations were sold for cash. Moreover as concerns the question of whether the obligations were "indebtedness," the *Hood* holders, unlike the holders at bar (R. 37), ranked *pari passu* with general creditors.

<sup>5</sup> It is true that the contingency involved in the *Equitable* case was a different contingency from the one concerned in the case at bar; there the "excess interest dividends" were payable at the discretion of the taxpayer's directors, whereas here the "liability" was not of a discretionary character. But the *Equitable* opinion indicates that if it had been clear that the payments were conditional upon earnings, the decision might have been rested on that ground also; in any event, whether discretionary or not, liability here was certainly conditional, for unless and until there were earnings, no "interest" was due.

## CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted,

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